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AMT Credit Relief for Losses on ISO Stock Sales

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As part of the Tax Relief and Health Care Act of 2006 (P.L. 109-432, December 20, 2006), the law now provides some benefit for previously unusable alternative minimum tax (AMT) credits, such as those created by the sale of stock acquired through the exercise of incentive stock options (ISO) for tax years beginning after December 20, 2006.

Background

The exercise of an ISO doesn't result in a regular tax liability in the year of exercise. The amount by which the stock is in the money (i.e., how much its value exceeds the exercise price) will be subject to regular tax as capital gain when the stock is ultimately sold. For AMT purposes, however, the amount that the stock is in the money represents an adjustment that increases AMT income in the year of exercise. For example, an employee is granted an ISO with an exercise price of $10. The price of the stock at exercise is $15. Since the stock is in the money, the employee exercises the ISO. The employee pays $10 to the company, incurs no regular tax liability on the exercise, and takes a $10 basis in the stock. For AMT purposes, the employee has an AMT income adjustment of $5 and takes a $15 basis in the stock. If the stock increases in value to $20 and the individual sells the stock, he or she will recognize $10 ($20 proceeds less $10 regular tax basis) of capital gain for regular tax purposes. The gain for AMT purposes will be $5 ($20 proceeds less $15 AMT basis). This results in a negative adjustment for AMT purposes, which potentially allows for the use of minimum tax credit.

A minimum tax credit is generated by the payment of AMT when the AMT payment is related to timing differences between the regular tax system and the AMT system, such as with the exercise of an ISO. When the stock is sold, the gain amounts are different for regular tax and AMT, reflecting the reversal of this timing difference. Items that don't generate a minimum tax credit include the standard deduction, personal exemptions, and a number of itemized deductions, such as miscellaneous itemized deductions.

The bursting of the tech stock bubble has created a problem for many employees whose stocks have gone down in value or become worthless. Returning to the example, if the stock becomes worthless after exercise, the employee has a capital loss of $10 for regular tax purposes ($0 proceeds less $10 tax basis). For AMT purposes, the employee has a loss of $15 ($0 proceeds less $15 AMT basis), again resulting in a negative $5 adjustment for AMT income. If the employee has substantial capital losses, it may not be possible to take advantage of them in the current year due to the $3,000 per year net capital loss limitation that applies to individual taxpayers. In addition, if the regular tax liability didn't exceed the tentative minimum tax, the taxpayer wouldn't receive a minimum tax credit. This is a harsh result for the taxpayer. The employee has paid AMT (potentially very large amounts) in an earlier year only to have the stock value on which the AMT was based to plummet. In effect, the taxpayer has paid a tax on a gain that ultimately didn't exist.

A number of recent tax cases address this issue. Taxpayers have failed in attempts to argue that the capital loss limitations don't apply the AMT losses and have asked the courts to force the IRS to accept an offer in compromise and refund part of the AMT paid in the year of exercise. The courts have noted that while the situation is troublesome, a law change would be required in order to alter the result.

Congress Addresses the Issue

The law now provides that an individual who has a long-term unused minimum tax credit (for a tax year beginning before January 1, 2013) will be allowed a minimum tax credit for that year. The credit will equal whichever amount is greater: either (a) the lesser of $5,000 or the unused credit or (b) 20% of the unused credit. The expression "long-term unused minimum tax credit" refers to tax years more than three years prior to the current tax year. The credit is refundable, but it should be noted that the refundable feature is phased out using the same phase-out ratio as for personal exemptions.

The following is based on an example from the Congressional Joint Committee on Taxation. It demonstrates the operation of the credit. Assume that an individual has a minimum tax credit of $1.1 million. Of that, $1 million is long-term unused minimum credit. Also assume that the individual has a regular tax liability of $45,000 and a tentative minimum tax (TMT) of $40,000, the taxpayer has no other credits allowable, and initially the taxpayer's income wasn't at a level that would cause a phase-out of exemptions. The credit is calculated as the greater of (a) $5,000 (the lesser of $5,000 or the unused long-term credit of $1 million) or (b) $200,000 (20% of the $1 million unused long-term credit). In this case the result is a $200,000 credit. Of that amount, $5,000 is a nonrefundable credit, and the remaining $195,000 is refundable. After offsetting the remaining $40,000 of tax ($195,000 less $40,000), it results in an overpayment and refund of $155,000. Note that the taxpayer would be entitled to only the nonrefundable $5,000 credit ($45,000 regular tax liability less $40,000 TMT) absent this provision.

Now assume that the taxpayer's adjusted gross income would result

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in a 50% reduction (using the exemption rules). In this case, the refundable amount is reduced to $95,000. After offsetting the tax liability, the result is an overpayment of $55,000.

A Compromise Solution

While not a perfect solution, the law is now attempting to address an issue that has proved troublesome to taxpayers who receive an ISO as part of their compensation. A preferable solution for taxpayers would have been to allow an offset (amended return) to the return for the year of exercise. This would allow an immediate refund of the amount paid in as AMT. Another preferable solution would have been to retroactively remove the AMT adjustment on exercise of an ISO. This also would have allowed an amended return opportunity to recover the AMT paid. The credit solution appears to represent a compromise between rectifying an unfair situation and making any loss in revenue to the government prospective rather than immediately refundable. ■

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